Supreme Court, U.S.
FILED

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No. A-185

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1994

R. A. HILDEBRAND and
DOROTHY A. HILDEBRAND WAHL,
Petitioners,
VS.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether the Tenth Circuit applied the proper standard, i.e. de novo or clearly erroneous, in reviewing the Tax Court's finding regarding profit objective for a business venture entered into by taxpayers, as to which the courts of appeals are in conflict.

2. Whether the Tenth Circuit applied the proper standard for determining profit objective for a business venture entered into by taxpayers, as to which the courts of appeals are in conflict.

3. Whether the Tenth Circuit improperly refused to apply prior decisions of this Court regarding a comparable sale to an independent third party to establish fair market value.

4. Whether debt obligations of the partnership in which taxpayers were limited partners were genuine.

5. Whether taxpayers should have been allowed deductions for certain of the expenses of the partnership as normal and customary business expenses under the bifurcated transaction doctrine.

6. Whether the increased rate of interest for substantial underpayments attributable to tax-motivated transactions under Internal Revenue Code section 6621(c) should have been imposed on taxpayers.

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IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1994

R.A. Hildebrand and
Dorothy A. Hildebrand Wahl, Petitioners,

v.

Commissioner of Internal Revenue,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

R.A. Hildebrand and Dorothy A. Hildebrand Wahl respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Tenth Circuit in this case.

OPINIONS BELOW

The opinion of the Court of Appeals for the Tenth Circuit (Appendix, pgs. 154 - 173) is reported at 28 F.3d 1024 (1994). The opinion of the United States Tax Court (Appendix, pgs. 1 - 153) is reported at 99 T.C. 132 (1992).

JURISDICTION

The Court of Appeals entered its judgment on June 22, 1994. On September 16, 1994, Associate Justice Ruth Bader Ginsberg issued an order extending the time for filing a petition for a writ of certiorari to and including October 20, 1994. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

Statutes involved in this case are all sections of the Internal Revenue Code, Title 26 of the United States Code. They include sections 161 (Allowance of Deductions), 162 (Trade or Business Expenses), 163 (Interest), 165 (Losses), 183 (Activities not Engaged in for Profit), 211 (Allowance of Deductions), 212 (Expenses for Production of Income) and 6621 (Determination of Rate of Interest). These sections are reproduced at Appendix, pgs. 174-184.

STATEMENT OF THE CASE

I. Procedural History

This petition is filed on behalf of R.A. Hildebrand and Dorothy A. Hildebrand Wahl ("Petitioners" or "Taxpayers") from a decision of the Tenth Circuit Court of Appeals which affirmed the decision of the United States Tax Court upholding the disallowance of deductions taken on their 1980, 1981 and 1982 income tax returns[1] and imposing the increased interest rate under Internal Revenue Code[2] section

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[1] Petitioner Wahl is only involved as to tax years 1980 and 1981 for which she and Petitioner Hildebrand filed joint tax returns; Petitioner Hildebrand filed a married filing separate return for tax year 1982.

[2] Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years in issue.

6621(c). Jurisdiction in the Tax Court was based on sections 6213(a) and 7442. Jurisdiction in the Tenth Circuit was based on section 7482(a). The principal findings of the Tax Court were that the activities of the partnership in which Petitioner Hildebrand was a limited partner were not engaged in with actual and honest profit objectives and that debt obligations of the partnership were not genuine.

This case, and a companion case,[3] are test cases for over 2,000 related cases and for a number of related partnerships for tax years beginning after 1983 ("TEFRA partnerships"). Alleged tax deficiencies at issue in connection with this group of related

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[3] The companion case is Gary E. Krause, Tax Matters Partner, Barton Enhanced Oil Production Income Fund v. Commissioner of Internal Revenue, United States Tax Court Docket No. 16425-86, United States Court of Appeals Tenth Circuit No. 93-9011. The two cases are entirely separate and distinct from one another for substantive purposes. They were formed and offered for sale to limited partners during substantially different time periods. Their business plans and actual operations were wholly distinct and separate from each other. Their general partners were not associated in any way and all factual and operational aspects of the different partnerships were wholly separate and apart from each other. They were consolidated for procedural purposes because they were handled as one group of cases internally by the Respondent, and so grouped by the Tax Court prior to the involvement of counsel for Petitioners.

cases and TEFRA partnerships are in excess of $2 billion.

II. Factual Overview

In 1980, Petitioner Hildebrand purchased three units as a limited partner in Technology Oil and Gas Associates, 1980 ("Technology 1980" or "Partnership"), a Utah limited partnership which was formed and began operations in 1980. The Partnership offered 250 limited partnership units for sale to qualified investors pursuant to a lengthy and detailed offering memorandum. The subscription price for each limited partnership unit was $230,000, payable partly in cash, partly in short term promissory notes and partly in long term obligations.

The investment objectives of the Partnership were: (1) To recover and sell gas located in the Monroe, Louisiana gas field, as well as in other oil and gas fields; (2) to use a portion of the net cash flow of the Partnership to acquire additional oil and gas properties over a 15-year period; and (3) to prove the economic feasibility of recovering oil from tar sands deposits located on properties through the use of special recovery technology. The more risky tar sands project was designed to provide large returns to the investors if successful. The conventional oil and gas project was designed to provide a stable financing base for the tar sands project and to provide a reasonable return to the investors if the tar sands project was not successful. The more risky tar sands

project was designed to provide large returns to the investors if successful.

The context of the Partnership's business is the energy crisis of 1979 and 1980, when world oil prices were increasing at unprecedented rates, with continuing price increases predicted. The Tax Court acknowledged the "energy price hysteria that existed in the late 1970s and early 1980s to invest in EOR technology." Government and industry both turned to alternative or synthetic sources of hydrocarbons, including tar sands, oil shale and coal liquefaction, which are present in vast quantities within the United States. Numerous governmental programs were designed to encourage private industry to develop these alternative sources of fuel which

were felt to be necessary for the continued growth of our economy, as well as for the political security of the United States.

Of these sources of alternative fuel, tar sands was believed to be the one that would make the first impact. The existence of substantial United States tar sands resources had been well known for years. We lacked only a viable method of recovering the bitumen from the tar sands deposits. Major governmental and private efforts were undertaken in the area of tar sands, which appeared economically feasible for the first time because of the large price increases for oil and projections of more increases. The Partnership's business was exactly

the type of activity the government was attempting to encourage.

In formulating the Partnership's business plan, the general partners[4] assumed that world oil prices would continue to increase. This was the safe and conservative position at that time as there was **complete agreement** among all prognosticators that prices would continue to rise; the only issue was how fast and how high.

The general partners and their representatives analyzed the Partnership business rigorously before selling

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[4] The corporate general partner, whose principals were oil and gas professionals with many years experience in the industry, and whose affiliate had a large staff of geologists and other oil and gas professionals, managed the business operations of the Partnership.

limited partnership interests. They consulted United States Government, Chase Econometrics and major oil company sources for current projections on world energy prices. Touche Ross & Co. performed a financial analysis of the economic structure of the Partnership's business. Most importantly, the general partners consulted a number of acknowledged experts on all aspects of the business plan.

III. Conventional Oil and Gas Project

In planning the conventional oil and gas project, the general partners determined that it was reasonable to expect success and profits therefrom. In reaching this conclusion they engaged

petroleum engineers to prepare production projections and had a discounted cash flow analysis of the proposed gas operation prepared. They arranged to receive the maximum price allowable under the Natural Gas Policy Act of 1978.

The Partnership planned to use approximately 33% of the initial cash proceeds received from limited partners to drill a series of low-risk developmental gas wells (and in fact did so), and to use a portion of the cash flow from these wells to drill an additional series of such wells (and, again, in fact did so).

The Monroe Field was mature and well documented; its reserves were well known. Production decline rates were

predictable, and operating costs were reasonable. Pipelines and gas gathering services were available, and there was a market for gas produced. The Monroe Field was a well recognized productive gas field and an industry accepted location for the drilling of new wells in 1979 and 1980. In 1979, for the fourth consecutive year, more gas wells were completed in the Monroe Field than in any other field in the United States.

While the first seven wells in the Monroe Field were commercially successful, production was less than anticipated. Alternate locations were thus obtained and the Partnership participated in the drilling of thirty-one wells in Ohio and nine wells in West

Virginia. All wells produced; none was a dry hole.

IV. Tar Sands Project

The specific tar sands properties acquired by the Partnership were chosen by a well qualified and knowledgeable expert regarding the tar sands properties and enhanced oil recovery. He chose approximately 745 acres containing approximately 51.2 million barrels of bitumen[5] in place for the Partnership, based on the best information available at the time, using standard geological and reservoir engineering methods to estimate how much oil in place was

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[5] Bitumen is the hydrocarbon resource in tar sands.

present on each parcel. The properties were acquired from TexOil International Corporation ("TexOil") for a combination of cash and Partnership promissory notes.

In order to recover the enormous quantities of bitumen on the Partnership's tar sands properties, an innovative and unconventional recovery technology, or a combination of technologies was considered necessary. The technology package licensed to the Partnership by Elektra Energy Corporation ("Elektra") appeared to contain a combination of technologies capable of the quick and economical extraction of some percentage of the bitumen from the Partnership's tar sands properties, with further development resulting in the

ability to extract larger percentages thereof.

The agreements between the Partnership and Elektra gave the Partnership the right to use all current and subsequently developed, acquired or licensed technology. The license fee was payable in a combination of cash and Partnership promissory notes.

Each Limited Partner assumed a pro rata portion of the Partnership's note obligation to Elektra and to TexOil. It was this obligation which created amounts with respect to which the Taxpayers were found to be at risk under section 465(b)(2) by the Tax Court in its opinion

on the cross-motions for summary judgment herein.[6]

The Partnership entered into a joint venture agreement[7] with other similarly situated partnerships pursuant to which they pooled all of their tar sands

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[6] 92 T.C. 1003 (1989). The Tax Court ruled, assuming for purposes of the cross-motions for summary judgment that the partnership debt obligations are genuine, (1) the Petitioners' assumption of partnership debt obligations created amounts with respect to which the Petitioners were at risk under section 465(b)(2), but only to the extent of the fixed and definite accruals each year on the debt obligations and only to the extent of the Petitioners' fixed and definite liability each year on the obligations; and (2) the Petitioners were not protected against loss under section 465(b)(4), on the partnership debt obligations they personally assumed. Other issues raised in the cross motions for summary judgment were denied as not ripe for summary disposition.

[7] Known as the "GEDCO Joint Venture."

resources. The joint venture expended millions of dollars in pilot projects toward the implementation of the technology to prove the economic viability of the tar sands project.

V. Status of Operations

Most of the Partnership's oil and gas wells are still producing, although the anticipated cash flow therefrom has not materialized because of lower production and lower natural gas prices. The Partnership retains its interest in the GEDCO Joint Venture, which retains substantial interests in the tar sands properties acquired by the Partnership and other related partnerships. Plans have been prepared for the next pilot

project, awaiting only a return of energy prices to 1980 levels.

The care taken by the general partners in forming and operating the Partnership shows clearly that only one factor -- the sudden and deep drop in projected oil prices -- transformed a promising business project into an unprofitable investment. Detailed financial analyses of the venture as of 1980 show a carefully financed business venture which sought to take advantage of the state of the economy and the energy market in 1980.

The business plan of the Partnership represented a good and relatively safe return to the investors **even if the risky tar sands part was a total failure**, since

the more conservative developmental oil and gas project would pay all of the tar sands obligations and still return the investors a reasonable profit; if the tar sands project had been successful, the investors would have realized very substantial profits. The Partnership's business was high risk, like most hydrocarbon energy ventures (generally about one in seven exploration wells is successful). The general partners believed, and subsequent expert assessments bear them out, that they had adequate information on which to make reasonable business projections. There can be no doubt that the technology which the Partnership licensed for use in proving the feasibility of bitumen recovery from its tar sands properties was innovative. Successful operation

would have opened up a significant new domestic hydrocarbon resource.

The financial risk of the tar sands venture was that there would be no successful demonstration pilot and that all the funds spent on the technology and the property would be lost. The Partnership hedged this risk by its conventional oil and gas operations to reduce the risks associated with the tar sands and serve as a financing vehicle. This is similar to what major oil companies do every day: carry on less risky developmental activities to hedge against high risk exploratory activities.

VI. Petitioner Hildebrand's Personal Due Diligence

Petitioner Hildebrand, who purchased three limited partnership units in Technology 1980, is a geological and mining engineer, formerly with Union Carbide, where he worked on secondary recovery projects, research and development, economic evaluations of ventures and feasibility studies. He drew on his own experience to review all the reports of experts attached as exhibits to the offering memorandum, including in particular the estimate of bitumen resources. Hildebrand knew that the presence of large deposits of bitumen in the areas of the Partnership's property was common knowledge in the industry and that this was confirmed by

reports of the United States Geological Survey and the Bureau of Mines.

Together with two friends, Hildebrand hired an independent geologic engineer to make a critical review of the offering materials. The engineer ended up investing himself after he made his study. Hildebrand also did his own net present value calculation of the venture, in the same manner as he had done on similar ventures at Union Carbide, and made the decision to invest.

Hildebrand testified that his motive for investing in the Partnership was to make a profit and that he didn't have enough income to take advantage of the deductions generated by the Partnership.

REASONS FOR GRANTING THE PETITION

This case involves tax issues of continuing importance and general applicability. In general, the Internal Revenue Code ("Code") allows deductions of ordinary and necessary expenses incurred in carrying on a trade or business. The test for determining whether expenses were incurred in connection with a trade or business is whether the subject activities were engaged in with a profit objective.

The first important issue involved herein is the standard of review which should be used by an appellate court in reviewing the finding of the Tax Court on the recurring issue of profit objective. Moreover, the proper standard of review

has far broader application than only in profit objective cases; the issue as to the proper standard of review arises every time a Tax Court decision involving mixed questions of law and fact is reviewed on appeal. There is substantial confusion on this issue and the decisions of the Court of Appeals are in conflict thereon.

This case also involves the legal standard for determining profit objective itself which applies in numerous recurring circumstances and is an issue of continuing importance and general application under the Code. It is also a standard on which the various Courts of Appeals are in conflict. This is a standard which requires classification and a decision by this Court.

An additional tax issue of continuing importance and general applicability involved in this case is the use of a comparable sale to an independent third party to establish fair market value. In a clear error of law, both the Tax Court and Tenth Circuit refused to apply prior decisions of this Court on this issue.

This case is a test case for over 2,000 related cases and for a number of related TEFRA partnerships. Alleged total tax deficiencies at issue in connection with this group of related cases are in excess of $2 billion. While the Tax Court is handling all of these cases on a group basis and is treating this case as a test case for the group, there is no agreement with the Tax Court

concerning the petitioners in the 2,000 related cases regarding this procedure or an agreement to be bound by the final decision in this test case. As a result, this case and the conflicts in the circuits as to the law applicable thereto take on greater importance because of the probability of multiple appeals to multiple circuits and the likelihood of conflicting decisions thereon. Under the circumstances, a decision by this Court on these issues becomes even more important.

Lastly, the decision in this case is unfair and unduly harsh in its impact because of changes in the economic circumstances and government energy and tax policy after investment was made in reliance thereon. At the time of

Petitioners' investment in 1980, the federal government sought and encouraged investments such as Petitioners' investment in the Partnership by the private sector through its national energy policy and the tax system. There was clear consensus in private industry and government alike that energy prices would continue to rise. Subsequent events proved every prognosticator of energy prices in 1980 to be wrong, with consequential changes in government energy and tax policy. Because of the Tax Court's hindsight reliance on such post-1980 changes, approved by the Tenth Circuit, Petitioners have been denied all tax deductions, including those for the cash they actually invested and lost (plus interest at the increased rate of 120% which was not even written into law

until 1984), all this from an investment which was in direct response to the President's plea to the nation regarding the energy crisis describing the response needed as "the moral equivalent of war."

I. There is a Conflict in the Circuits on the Standard of Review Regarding Profit Objective

While it is universally agreed that findings of fact of a lower court are reviewed on appeal on a clearly erroneous standard whereas findings of law are reviewed de novo, the application of these seemingly simple rules is often difficult and has resulted in substantial conflicts among the circuits as to the proper standard in reviewing lower court findings on various tax issues. While

many courts have attempted to define the meaning of the clearly erroneous standard it has no intrinsic meaning and has been referred to as elastic, malleable and variable to change with the facts and circumstances under review.

Most important for the present case are those issues that have been characterized as mixed questions of law and fact, on which the circuits are in substantial disagreement. While some circuits take the position that mixed questions of law and fact come within the clearly erroneous standard of review, the weight of authority appears to be that mixed questions of law and fact are treated as questions of law and reviewed de novo.

Whether a taxpayer has engaged in activities with an actual and honest profit objective, which is the issue decided by the Tax Court in this case, has been recognized as a mixed question of law and fact since the enactment of section 183 in 1969. The split in the circuits regarding the standard of review of such mixed questions is substantial. The Second and Seventh Circuits review mixed questions using a clearly erroneous standard. Bausch & Lomb, Inc. v. Commissioner, 933 F.2d 1084 (2nd Cir. 1991); Eli Lilly & Co. v. Commissioner, 856 F.2d 855 (7th Cir. 1988). The Fourth, Sixth, Eighth, Ninth and Eleventh Circuits review such mixed questions de novo. Black & Decker Corp. v. Commissioner, 986 F.2d 60 (4th Cir. 1993); Jolin v. Commissioner, 869 F.2d

1491 (6th Cir. 1991); Estate of Vak, 973 F.2d 1409 (8th Cir. 1992) and Sargent v. Commissioner, 929 F.2d 1252 (8th Cir. 1991) (mixed questions of law and fact requiring consideration of legal concepts and involving exercise of judgment about values underlying legal principles are reviewable de novo); Moss v. Commissioner, 931 F.2d 833 (9th Cir. 1987); Feldman v. Commissioner, 20 F.3d 1128 (11th Cir. 1994) (ultimate facts reviewable de novo).

Further analysis evidences an even deeper split in the circuits. The Sixth Circuit, which generally follows the de novo standard on mixed questions of law and fact, is consistent therein and has held that a Tax Court finding of sham is reviewable de novo. Bryant v.

Commissioner, 928 F.2d 745 (6th Cir. 1991). The Ninth Circuit, which also generally follows the de novo standard, has held that a Tax Court finding of sham is reviewable under a clearly erroneous standard. Sochin v. Commissioner, 843 F.2d 351 (9th Cir. 1988), cert. denied 488 U.S. 824 (1988). However, the Ninth Circuit has also held that a Tax Court finding on the issue of profit motive is reviewable de novo. North Ridge Country Club v. Commissioner, 877 F.2d 750 (9th Cir. 1989) (other Ninth Circuit cases apply a clearly erroneous standard).

The Tenth Circuit has gone out on its own on this issue and carved out a standard that causes even more uncertainty and confusion because it can change depending on the case. Its

standard is that mixed questions of law and fact are reviewable de novo or on a clearly erroneous basis depending on whether factual or legal issues predominate. Egner v. Commissioner, 936 F.2d 582 (10th Cir. 1991); NCAA v. Commissioner, 914 F.2d 1417 (10th Cir. 1990). This represents a change in the Tenth Circuit's historical standard on this issue which followed the majority view that a Tax Court's findings of law and of ultimate facts from applying legal principles to facts are subject to de novo review. Yates v. Commissioner, 924 F.2d 967 (10th Cir. 1991); First National Bank in Albuquerque v. Commissioner, 921 F.2d 1081 (10th Cir. 1990). Under that standard, the Tax Court's ultimate conclusion that the activities of the Partnership in which Petitioners were

limited partners were not engaged in with actual and honest profit objectives should have been reviewed de novo. James v. Commissioner, 899 F.2d 905 (10th Cir. 1990); Miller v. Commissioner, 836 F.2d 1274 (10th Cir. 1988). The Tenth Circuit's use of the clearly erroneous standard in Cannon v. Commissioner, 949 F.2d 345 (10th Cir. 1991) and this case is a change from its prior standard, is in direct conflict with the Ninth Circuit's standard in North Ridge, supra, and is in conflict with the weight of authority in the other circuits.

II. There is a Conflict in the Circuits on the Standard for Determining Profit Objective

The conflict in the circuits on the standard for determining profit objective is best illustrated by a discussion of the different standards in Dreicer v. Commissioner, 665 F.2d 1292 (D.C. Cir. 1981), finding that the proper standard is "when profit is actually and honestly his (taxpayer's) objective though the prospect of achieving it may seem dim". This conflict can be characterized as between an objective and subjective standard or "reasonable expectation of profit" versus "bona fide profit objective." The court analyzed the legislative history and intent in adopting section 183 and noted that the

Senate rejected the House version which required a "reasonable expectation of realizing a profit" and placed the focus on whether the activity is engaged in for the purpose of profit rather than whether the expectation of profit is reasonable. section 183 as adopted followed the Senate version. Thus, the rule disallowing deductions should not apply to situations where many would consider that it is not reasonable to expect an activity to result in a profit even though the evidence available indicates that the activity actually is engaged in for the purpose of profit (for example, a wildcat oil well). In determining whether the subjective standard of profit objective is met, reference is properly made to objective standards taking into

account all of the facts and circumstances of each case.

In Dreicer, the court noted the Tax Court gave lip service to the proper subjective standard by conceding that the taxpayer need not show an expectation of profit that could be deemed reasonable, but then in fact went on to apply the improper reasonable expectation standard by requiring a "bona fide expectation of profit." Such a test focuses improperly on profit expectation, not profit objective under the statute. The goal, not the reasonable expectation, of making a profit is what controls and the two criteria are not the same.

Although the Court in Dreicer correctly points out that the test

mandated by the statute (and the regulations promulgated thereunder) is bona fide profit motive, there is a conflict among the circuits thereon. Several circuits have drawn on language in the test used in a number of cases for measuring whether a transaction has economic substance (sometimes referred to as the "sham" test) which looks to the objective economic reasonableness of the transaction. Indeed, in the present case, the Tax Court applied, and the Tenth Circuit approved, the use of just such an objective economic reasonableness test even though the issue of sham was never considered by either court.

A number of circuits, including the First, Fifth, Sixth, Eighth, and Ninth, follow the basic rule of section 183.

Dewees v. Commissioner, 870 F.2d 21 (1st Cir. 1989) (profit motive test means that the taxpayers, in entering into the transaction, must have been primarily motivated by the desire to make a profit); Agro Sci. v. Commissioner, 934 F.2d 573 (5th Cir. 1991) (expenditures may only be deducted under sections 162, 174, and 212 if the facts and circumstances indicate that the taxpayer made them primarily in furtherance of a bona fide profit objective independent of tax consequences); Hayden v. Commissioner, 889 F.2d 2548 (6th Cir. 1989) (the threshold inquiry in determining whether an activity is a trade or business or is carried on for the production of income is whether the activity is engaged in for the primary purpose and dominant hope and intent of

realizing a profit); Evans v. Commissioner, 908 F.2d 369 (8th Cir. 1990) (while a reasonable expectation of profit is not required, a bona fide objective of realizing a profit must exist); Mattfeld v. Commissioner, 15 F.3d 1087 (9th Cir. 1994) (profit must be the dominant or primary objective of the venture). The Second, Fourth and now the Tenth Circuits apply a more objective standard than was intended by the drafters of section 183. Gilman v. Commissioner, 933 F.2d 143 (2nd Cir. 1991) (reasonable opportunity for economic profit and reasonable possibility of profit); Antonides v. Commissioner, 893 F.2d 656 (4th Cir. 1990) (anticipation of making a profit on operations within the foreseeable future); Hines v. United States 912 F.2d

736 (4th Cir. 1990) (expectation of profit independent of the tax benefits); Nickeson v. Commissioner, 962 F.2d 973 (10th Cir. 1992) (use of a test that emphasizes objective factors). In this case, the Tax Court and Tenth Circuit applied the improper reasonable expectation standard, relying in error on hindsight and the Tax Court's own objective economic analysis. Bryant v. Commissioner, supra, 928 F.2d 745 (a sham case in which the Tax Court's financial analysis of the merit of the investment, in the light of hindsight, was rejected by the Sixth Circuit); Evans, supra, 908 F.2d 369.

III. The Tenth Circuit Refused to Apply Prior Decisions of this Court Regarding a Comparable Sale to an Independent Third Party to Establish Fair Market Value

The Tax Court and Tenth Circuit made a glaring error of law which taints the analysis of actual and honest profit motive and undercuts the holding in this case; they disregarded the best evidence of the real value of the Partnership business: the demand in the marketplace.

In early 1981, after the Partnership had formed the GEDCO Joint Venture, Pogo Producing Company ("Pogo"), a publicly traded energy corporation, acquired a 5% working interest in one of the joint venture's projects plus an option to

acquire similar 5% interests in future projects of the joint venture. Pogo agreed to pay approximately $2.3 million for these interests. This acquisition presents a textbook example of a transaction between an unrelated buyer and seller, neither under any compulsion to do the transaction and both with possession of the relevant facts. United States v. Cartwright, 411 U.S. 546, 551 (1973).

The valuation of assets for tax purposes is the subject of a huge body of law, but in every case fair market value must first be tested against the price at which the property would change hands between a willing buyer and a willing seller if such a comparable transaction exists. Treas. Regs. Sec.

1.482-1T(b)(2)(iii). Such an uncontrolled transaction is the master measuring stick against which a taxpayer's, or the Commissioner's, designation of correctness of value is tested. The Commissioner's own regulations provide that in validating the consideration paid or incurred in a transaction, one **first** compares such transaction to one in which the same or similar property is the subject and in which the parties are uncontrolled to each other. Only if there is no such transaction (sometimes called a "Comparable Uncontrolled Transaction") does one then resort to other means of valuing the assets in question. Treas. Regs. §1.482-1T(b)(2)(iii). This rule of law is as clear and as definitive as any

rule in the canon of federal income tax law. Cartwright, supra, at 551.

In this case, the Tax Court and Tenth Circuit erred by refusing to consider the evidence of just such a Comparable Uncontrolled Transaction, namely, the acquisition for $2.3 million by a publicly traded company of an undivided percentage interest in a portion of the tar sands business of the Partnership. Appellants respectfully submit that the refusal of the Tax Court and Tenth Circuit to assign any weight to the Pogo transaction constitutes a reversible error of law and undercuts the principal findings of fact in this case.

IV. The Tenth Circuit Committed Other Reversible Error

The finding that the debt obligations of the Partnership did not constitute genuine debt obligations and are to be disregarded cannot be sustained. The authority relied upon by the Tax Court is inapplicable; one case involved non-recourse obligations and the other deductions for accrued interest on property not owned. Here the obligations to Elektra and TexOil were fully recourse to Petitioners to the extent of their pro rata assumption thereof[8] and must be recognized as genuine debt obligations. Smith v. Commissioner, 937 F.2d 1089 (6th

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[8] As found by the Tax Court on the cross-motions for summary judgment, 92 T.C. 1003 (1989).

Cir. 1991); Bryant v. Commissioner, supra, 928 F.2d 745; Melvin v. Commissioner, 88 T.C. 63 (1987), affirmed, 894 F.2d 1072 (9th Cir. 1990); and Pritchett v. Commissioner, 827 F.2d 644 (9th Cir. 1987).

The court further erred by not allowing Petitioners a portion of the disallowed deductions under the "bifurcated transaction" doctrine. James v. Commissioner, supra, 899 F.2d at 910 (allowance by Tenth Circuit of interest and other deductions). Pursuant thereto, even "a sham transaction may contain elements whose form reflects economic substance and whose normal tax consequences may not therefore be disregarded." Id., citing Rice's Toyota World v. Commissioner, 752 F.2d 89, 96

(4th Cir. 1985). See also, Smith, supra, where the Sixth Circuit found that even if the underlying transaction was found to be a sham, claimed interest on the notes to third parties (in the position of Elektra and TexOil herein) is deductible. 937 F.2d at 1098.

Petitioners made cash payments of $10,000 per unit to the Partnership in each of the first three years of its existence (plus interest on the payments made in the second and third years). They also became personally liable to Elektra and TexOil for a pro rata portion of the Partnership's notes to Elektra and TexOil. Substantial portions of the cash paid by Petitioners went to the costs of oil and gas wells which were actually drilled, the cost of the tar sands

projects which actually took place and numerous other normal and customary business expenses. At the least, such cash expenditures should have been allowed as deductions.

Lastly, in light of the findings in favor of Petitioners on all other additions to tax and increased interest claimed by Respondent, the increased rate of interest for substantial underpayments attributable to tax-motivated transactions under section 6621(c), and its predecessor section 6621(d), was imposed in error. As specifically found by the Tax Court, the government was encouraging investments in the development of tertiary oil recovery methods, such as EOR technology. As noted by the Tax Court, one of

Respondent's own experts acknowledged investors may have been "significantly and reasonably influenced" by the energy price hysteria to invest in EOR technology. There were numerous government incentives directed at the development of EOR technology and huge amounts of public and private money were being spent thereon in spite of the fact that technology was not technically viable at the time and only minimal oil was produced therefrom. Petitioners herein should not be singled out for penalties for participating in President Carter's publicly expressed national energy policy. Their investment was encouraged and requested by the President and Congress and they should not suffer as a result of a subsequent change in economic conditions and government energy

policy. The imposition of this increased rate is simply one example of the unfairness and unduly harsh impact of this case on Petitioners and the hundreds of others similarly situated discussed in more detail in the introduction to "Reasons for Granting the Petition."

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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